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July 15, 1996

**Ms. Regina Keeney**  
Chief - Common Carrier Bureau  
Federal Communications Commission  
1919 M Street, N.W., Rm. 500  
Washington, D.C. 20554

**Re: CC Docket 96-98**

Dear Ms. Keeney:

Many thanks to you and your staff for taking time from your very hectic schedules to meet with Alfred Kahn to discuss the interconnection proceeding. I have taken the liberty of attaching the declaration that Professor Kahn submitted in support of our reply comments in this proceeding. I recognize that you are probably swimming in paper and thought that a separated attachment of Professor Kahn's declaration, and a brief summary prepared by him, might be helpful in putting his comments from the meeting into full context.

If you have any questions please do not hesitate to contact me.

Sincerely,

*Pat Koch*

Attachment

cc: L. Atlas  
R. Metzger  
G. Rosston  
L. Selzer  
D. Stockdale

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**THE PRICING OF CARRIER ACCESS  
AND OF UNBUNDLED NETWORK ELEMENTS**

Alfred E. Kahn

1. Any transition to full blown competition in telecommunications must take into account the current condition of the industry and the nature of the comprehensive regulation to which it continues to be subject, if the competition is to be efficient and if it is to encourage the accelerated deployment of advanced telecommunications and information technologies.
2. The pricing of telecommunications services is shot through with regulatorily-mandated cross-subsidizations, the principal ones of which involve pricing toll, basic dialtone service to business customers, particularly in metropolitan areas, vertical and carrier access services far above cost in order to hold down the basic residential charge.
3. The state PUCs and the FCC have recognized the continuing need of the LECs to charge much more than incremental cost for the overpriced services and for such essential inputs as carrier access and collocation services, if they are to continue to offer the cross-subsidized services, to maintain and extend the ubiquitous telephone network and recover joint and common costs incurred in fulfillment of their public utility obligations.
4. The result, however, has been to attract competitors into the overcharged markets—competitors who may or may not be more efficient than the incumbent LECs, because they are competing against prices that are far above the costs of the incumbents themselves.
5. In these circumstances, the demand by the IXC's and their witnesses that the LECs be required to supply them with unbundled network elements at bare TSLRIC betrays a shocking inconsistency on the part of some of them and of AT&T itself, in terms of what they have demanded in other contexts. Moreover, those witnesses would define that TSLRIC as not the actual incremental cost that would be incurred by the LECs but a hypothetical measure of the cost of constructing an entirely new network from scratch, on the theory that this is the level to which prices would be driven in a competitive market. In this, they are simply wrong. As a

large number of economists have pointed out over at least 40 years, it would be irrational, in a world of continuous technological progress, for firms constantly to incur the huge sunk costs of totally updating their facilities in order completely to incorporate today's lowest cost technology, because such investments would instantaneously be outdated tomorrow and, in consequence, would never earn a return sufficient to justify them. The proper target for competitive LECs to aim at is the TSLRIC of the incumbent LEC: if they can do better than that they should be encouraged to enter and pocket the difference; if their own incremental costs are higher than those of the incumbent, they should be discouraged from entering.

6. The proposed pricing of unbundled inputs at bare incremental cost demanded by the IXC's would

- grossly discourage facilities-based entry: there would be no point in would-be competitive LEC's constructing their own networks if they could purchase those elements instead from the incumbents at that unrealistically low bare TSLRIC. The central purpose of the new Act—the expansion of modern telecommunications infrastructure—would therefore be frustrated;
- enable the IXC's by piecing together a local exchange network through purchases of the several elements at such a price, totally to circumvent the carrier access charges established by the FCC and the state PUCs to give the LECs a fair shot at recovering their total prudently-incurred costs;
- wipe out the contribution from the overpriced services that the several commissions, State and Federal, have determined to be necessary to permit the LECs to keep basic residential rates low and to construct and maintain their ubiquitous networks—contributions that will continue to be necessary unless and until either the need is eliminated by rebalancing rates or alternative universal service funding mechanisms are introduced;
- preclude the state PUCs from determining the requisite markups even though they alone are in a position to do so in light of the circumstances of each individual LEC, which vary widely from state to state; and

- render totally vacuous the resale provisions of the Act, which require the LECs to make such overpriced retail services as vertical or toll services available to competitors at retail price less avoided cost. No competitive carrier would make use of that provision if it could instead acquire the network elements necessary to provide those highly remunerative services at bare LRIC.

7. Permitting the LECs to incorporate markups above LRIC in their charges for unbundled network elements would not erect a barrier to the entry of equally efficient competitors, since the LECs would be required to continue to incorporate those same charges in their own prices of the competitive services. On the contrary, it is essential that competitors have imposed on them the same costs as the LECs have been forced by regulators to recover in those prices, if the competition between them is to be determined by their relative efficiency.

8. The contention by AT&T witnesses that permitting LECs to incorporate such markups in their charges would "lock-in monopoly profits" ignores the fact that the charges would continue to be subject to strict regulatory determination as no greater than necessary to equalize the competition between the rivals and to provide the incumbent LECs with a reasonable opportunity to recover their legitimately-incurred costs.

9. The proper distribution of authority between the FCC and the state commissions is for the former agency to instruct the latter to permit markups above the LECs' own incremental costs necessary—but no larger than necessary—to give the companies a fair opportunity to recover their total costs—joint and common, current and historical—while at the same time giving them strong incentives to minimize those costs by subjecting their rates to indexed caps that automatically pass on to their customers reasonably achievable improvements in efficiency.